

Anzu Partners LLC  
Bee Partners Management Company, LLC  
Blue Tree Capital Group  
Cottonwood Technology Fund

Rhapsody Venture Partners  
Scout Ventures  
Thin Line Capital, LLC

May 10, 2022

Submitted via email to: [rule-comments@sec.gov](mailto:rule-comments@sec.gov)

Vanessa Countryman, Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-0609

**Re: Private Fund Advisers; Documentation of Registered Investment Adviser  
Compliance Reviews (File No. S7-03-22)**

Dear Ms. Countryman:

This letter is submitted in response to the request for comments by the U.S. Securities and Exchange Commission (the “Commission”) regarding proposed rules relating to private funds (the “Proposed Rules”) under the Investment Advisers Act of 1940 (the “Advisers Act”). The Proposed Rules are set out in SEC Release No. IA-5955 (Feb. 9, 2018).

**Background**

On February 9, 2022, the Commission proposed six new rules and two rule amendments:

- Rule 211(h)(1)-1, which would establish definitions applicable to the other Proposed Rules;
- Rule 211(h)(1)-2, which would require the delivery of quarterly statements to private fund investors and include specific requirements for such statements;
- Rule 211(h)(2)-1, which would prohibit certain activities by private fund advisers;
- Rule 211(h)(2)-2, which would require a fairness opinion and related disclosures for adviser-led secondary transactions relating to a private fund;
- Rule 211(h)(2)-3, which would prohibit certain forms of preferential treatment that an adviser to a private fund could reasonably expect to have a material, negative effect on other investors in that private fund;
- Rule 206(4)-10, which would require an annual audit for every private fund managed by a registered investment adviser;
- amendments to Advisers Act Rule 206(4)-7, which would require documentation of annual compliance reviews conducted under Rule 206(4)-7; and
- amendments to Advisers Act Rule 204-2, which would create new books and records obligations applicable to requirements established by the other Proposed Rules.

We have reviewed the comment letter submitted by the National Venture Capital Association and generally concur with the comments set forth in that letter. We would, however, like to specifically comment on proposed Rule 211(h)(2)-1 which, as proposed, would prohibit an investment adviser to a private fund from entering into certain indemnification and waiver agreements in connection with providing services to a private fund. In our view, proposed Rule 211(h)(2)-1 is inconsistent with the Commission's mission to facilitate capital formation because it could meaningfully decrease a venture capital fund adviser's willingness to invest in pre-revenue portfolio companies or to allow its personnel to work with portfolio companies (e.g., as officers or directors of such companies) to help a start-up company reach profitability.

### **Proposed Rule 211(h)(2)-1**

Proposed Rule 211(h)(2)-1 would prohibit an investment adviser, directly or indirectly, from seeking reimbursement, indemnification, exculpation, or limitation of liability from a private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, recklessness, or negligence in providing services to the private fund. The Commission stated that its examination staff has observed private fund agreements that state that a private fund adviser will not be subject to any duties or standards (including fiduciary or similar duties or standards) existing under the Advisers Act, Delaware law, or Cayman Islands law (to the maximum extent permitted by applicable law) and that such a waiver of compliance with an adviser's fiduciary duty under the Advisers Act is invalid under the Advisers Act. Our view is that mandating a simple negligence standard of care is not necessary to address the Commission's stated concern.

We will leave to others a full discussion of whether the Commission has adequate authority under Section 211 or Section 206 of the Advisers Act to adopt Rule 211(h)(2)-1.<sup>1</sup> Instead, we address below the more practical issue that the Commission's proposal unnecessarily seeks to protect investors that have a high level of sophistication, and often independent advice, when making their investment decisions. Such investors do not need the proposed protection. We also address the negative effect the proposal will have on small, start-up companies seeking not only to raise funds, but also to benefit from their relationships with experienced venture capital fund investors in operating and growing their businesses.

*Private Fund Investors Do Not Need Commission Help Negotiating Contractual Standards of Care.* Investors in private funds are limited to individuals and entities that meet the definition of "accredited investors" contained in Rule 502 under the Securities Act of 1933. In general, accredited investors have a certain level of "financial sophistication and [the] ability to sustain the risk of loss of investment or fend for themselves."<sup>2</sup> Historically, that determination was made primarily based on net worth or a certain level of income. More recently, however, the definition was expanded to include individuals and entities that demonstrate, by professional certification or relevant experience, that they have the ability to analyze the risks and rewards of an investment opportunity, the capacity to allocate investments in such a way as to mitigate or avoid

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<sup>1</sup> We do, however, concur with commenters who view this proposal as inconsistent with Congress's intent, when it enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act, to differentiate between venture capital fund advisers and other types of investment advisers.

<sup>2</sup> See Regulation D Revisions; Exemption for Certain Employee Benefit Plans, Release No. 33-6683 (Jan. 16, 1987).

risks of loss, or the ability to access information about an issuer or an investment opportunity.<sup>3</sup> Such investors are capable not only of evaluating investment opportunities, but also of making decisions regarding the appropriate standard of care to be applied to their financial relationships. Eliminating the ability of these sophisticated investors to negotiate the terms of such relationships is unnecessary and inconsistent with the Commission's determination that they are capable of making the risk determination inherent in agreeing to a higher standard of care. This is particularly the case given that certain state and federal laws already preclude many parties from contractually waiving negligence claims in many contexts.

*The Proposed Rule Would Subject Private Fund Advisers to Significant Litigation Risk.* The lower standard of care contained in proposed Rule 211(h)(2)-1 would expose private fund advisers to a significant increase in the risk of litigation for simple negligence claims.<sup>4</sup> As a result, private fund advisers would seek to mitigate such risk. One of the simplest means of doing so would be to preclude an adviser's principals from providing managerial or operational consulting services to portfolio companies. Instead, the business of the fund and its adviser would be limited to making equity investments with no "value add" services. In our view, this would decrease the total value of a venture capital fund's investment into its portfolio companies, and could affect the profitability of such companies. Moreover, if the rule is adopted as proposed, we believe that it will substantially chill new venture investments, particularly in small, pre-revenue companies operating in highly regulated industries, until participants in the private fund market have a better understanding of how the courts and the Commission will interpret this revised standard of care.

*Investors in Venture Capital Funds Expect Funds to Take on Risks.* Venture capital funds (and their advisers) are paid to take risks on behalf of fund investors. Venture capital funds fully describe the risks of investing with them, consistent with the fiduciary obligation of the advisers to such funds, enabling sophisticated, accredited investors to make an informed decision to take on such risk. Such investors appreciate that such level of risk is often necessary in order to bring new technologies and products to market. For example:

- a. **Company X** makes permanent magnets without rare earth metals. The strategic importance and potential environmental benefits of this business are massive, and it has received government support from the U.S. Department of Energy and private capital from large institutional investors. Nonetheless, the company has no revenue, has never made a profit, and may not make a profit for the foreseeable future. Investors in funds holding this issuer are aware of the risk and the time horizon. However, it is possible that one could argue that such an investment – particularly at meaningful valuations – would not meet the standard of care in proposed Rule 211(h)(2)-1. We strongly believe this investment is in the long-term best interests of fund investors, but reasonable minds can differ, and a simple

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<sup>3</sup> See Accredited Investor Definition, Release No. 33-10824 (Aug. 26, 2020).

<sup>4</sup> While many sophisticated institutions and endowments are unlikely to engage in such costly and nuanced litigation, we believe that certain high-net-worth individuals (including some who are not original investors, but who have obtained fund positions through an estate or divorce) are more likely to pursue this type of litigation, to the detriment of the funds and other investors.

negligence standard could expose the adviser to unsupportable litigation around this issue.

- b. **Company Y** received the first FDA approved diagnostic for concussions, potentially saving patients and doctors from unnecessary radiation during CAT scans. For most of its existence as a private company, it had no revenues and no profits. Funds invested in this holding prior to FDA approval based on a strong understanding of the company's business model and expectation of regulatory approval, and eventually the company was acquired by a large multi-national biotechnology company. However, until such point, an argument could have been made that a large position in this pre-revenue company was not consistent with the standard of care espoused by the Commission.
- c. **Moderna**, which we all know developed one of the most effective COVID-19 vaccines using previously untested medical technology] did not make a profit until 2021. Until that point, holding Moderna was a high-risk investment to make, with no certainty of return.

*The Proposed Rule would Decrease the Willingness of Venture Fund Advisers to Take on Responsibilities with Portfolio Companies.* For venture capital investments to work effectively, venture capital personnel often take on responsibilities within portfolio companies, including positions as officers and directors. Having firm personnel in those positions improves the profitability of portfolio companies and enhances returns for fund investors. But such positions also require individuals to exercise judgment and, as a result, increase such individuals' exposure to liability. Venture capital funds currently rely on contractual liability limitation provisions to protect firm personnel from simple negligence claims, allowing them to step into those positions for the benefit of the fund and its portfolio companies. The Commission's proposal to ban provisions indemnifying advisers and their employees even for mere negligence, would destabilize existing industry practice, and stifle capital formation and economic growth.

For the reasons set forth above, we believe the proposal to prohibit an investment adviser, directly or indirectly, from seeking reimbursement, indemnification, exculpation, or limitation of liability from a private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, recklessness, or negligence in providing services to the private fund would have a chilling effect on capital formation, particularly by small, pre-revenue companies held by venture capital funds.

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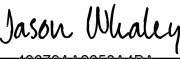
We appreciate the opportunity to comment on the rule proposal, and welcome any questions from the Commission or its staff.

Sincerely,

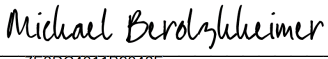
**Anzu Partners LLC**

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By:   
Name: Whitney Haring-Smith  
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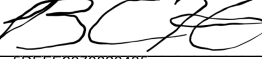
**Rhapsody Venture Partners**

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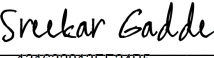
**Bee Partners Management Company, LLC**

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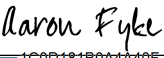
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